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Directorate of
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International
Economic & Energy
Weekly

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4 February 1983

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4 February 1983

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International Economic & Energy Weekly [redacted]

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4 February 1983

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Comments and queries regarding this publication are welcome. They may be directed to [redacted] *Directorate of Intelligence,* [redacted] 25X1

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International Economic & Energy Weekly

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Synopsis

Perspective—*South American Debt Problems Spreading* 25X1

New lending to South America continues to slow, jeopardizing the region's ability to service its $210 billion foreign debt, about 30 percent of the LDC total. South American borrowers are increasingly tempted to resort to extreme actions to resolve their financial problems. 25X1

Ecuador: The Debt Problem 25X1

Quito started negotiations with its creditor banks in late 1982 when it became apparent that it could not cope with mounting debt strains. Final approval of recent tentative agreements to refinance $5.6 billion of public debt is contingent upon the outcome of ongoing negotiations with the IMF. 25X1

Japan: Fiscal Constraints on Industrial Policy 25X1

Tokyo's concern over its mounting fiscal deficit will constrain industrial policy related expenditures in FY 1983. MITI has partially compensated for the tight budget by increasing funds available through various government lending institutions. 25X1

Japan: Evolving Policy Toward the Third World 25X1

Foreign aid, particularly to strategically important Third World countries, has increased rapidly since the mid-1970s. We expect this trend to continue under Prime Minister Nakasone, although budget problems will slow the increase in aid commitments. 25X1

West German Arms Sales: Policies and Prospects 25X1

West Germany, the world's fifth leading arms supplier, is likely to encourage more arms sales to strengthen the domestic economy and its national defense. Nevertheless, we believe West Germany will have difficulty holding its market share over the next several years. 25X1

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International Economic & Energy Weekly (U)

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Perspective

South American Debt Problems Spreading 25X1

New lending to South America continues to slow, jeopardizing the region's ability to service its $210 billion foreign debt, about 30 percent of the LDC total. Smaller foreign banks are refusing loan requests outright, demanding repayment of maturing loans, and reducing short-term credit commitments. 25X1

Brazil's current financial bind illustrates the severe impact of the lending slowdown. Since late December, a steady rise in requests for repayment of maturing short-term loans has caused Brazilian banks difficulty in meeting daily foreign exchange requirements. Creditors' failure to restore short-term credit lines are now jeopardizing the success of Brazil's balance-of-payments financing plan for 1983 and the finanical position of Brazilian institutions operating in overseas markets. The Bank of Brazil could face bankruptcy, probably forcing Brasilia to declare a temporary moratorium on all debt repayments. Such a declaration probably would lead to a temporary cessation of all foreign lending, thereby forcing larger-than-anticipated import cutbacks and economic retrenchments. 25X1

Even if Brazil meets scheduled payments, its publicized financial problems will heighten banker perceptions of risk for the region. Chile and Venezuela are now encountering debt problems while Peru is vulnerable to another credit contraction; Argentina already is rescheduling.

- Santiago had to begin talks in late January to reschedule $4.8 billion in maturing foreign debt. It also hoped to convince creditors to resume new lending—halted after a recent financial dispute with the government—but their unwillingness to do so caused Santiago to declare a 90-day moratorium on debt repayments last weekend.

- Venezuela is in financial trouble because of a loss of banker confidence; mounting arrearages over the past month have undermined the government's plans to refinance maturing short-term public debt.

- Argentina remains vulnerable to another credit contraction because of its need to arrange new financing and to roll over maturing debts. Smaller US banks, increasingly concerned about political developments in the country, are not lending except in the rescheduling package.

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- Peru is also encountering difficulty in obtaining longer term credits, despite its willingness to pay higher rates. With limited financial maneuvering room, Peru may join neighboring Bolivia and Ecuador in debt-restructuring talks. [redacted] 25X1

Debt problems are forcing economic retrenchment throughout South America. Argentina, Brazil, Chile, and Peru—accounting for 85 percent of regional GNP—are undertaking IMF stabilization programs this year. South American intraregional trade and payments links will exaggerate the effect of these austerity programs. In 1981, for example, Brazil and Argentina each sold about 20 percent of their exports to other South American countries and purchased about 15 percent of their imports from them. Bolivia, Paraguay, and Uruguay probably will find it increasingly difficult to meet debt payments and import bills because of their heavy dependence on sales to their troubled neighbors. [redacted] 25X1

Latin debt problems will hinder global recovery. Cutbacks in imports and tighter exchange controls will increasingly restrict developed countries' exports to the region, hamper the repatriation of profits, and slow overall recovery from the global recession. The United States will be especially hard hit. In 1982, for example, US banks had about $50 billion in outstanding loans to the region, US manufacturers had some $20 billion in direct investments, and US exports totaled about $17 billion. [redacted] 25X1

South American debt problems have yet to precipitate a financial crisis. Instead, Argentina and Brazil are both receiving support from major banks in assembling necessary balance-of-payments financing plans. Ecuador is also rescheduling maturing debts. [redacted] 25X1

For the next few months, however, major banks in the United States and other industrial countries may again be called on to provide a quick infusion of cash to these borrowers to avert a liquidity crisis. If smaller institutions continue to reduce their lending, debt servicing will become unmanageable. [redacted] 25X1

South American borrowers are increasingly tempted to resort to drastic measures to resolve their financial problems. In early December, Buenos Aires unilaterally rescheduled some $5 billion. Later in the month, Brasilia announced a suspension of principal payments for January and February. Most recently, Chile has declared a 90-day standstill on debt repayments before it exhausted international reserves. Domestic political support is growing for collective action by South American debtors, but Embassy [redacted] 25X1
sources have yet to detect any official support for outright debt repudiation. [redacted] 25X1

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Briefs

Energy

1982 Soviet Oil Production

Oil production in the USSR increased less than 1 percent in 1982 and fell slightly below the official target. The USSR reported that production of oil and gas condensate during 1982 was 613 million tons, or 12.26 million barrels per day. This is slightly less than the planned goal of 614 million tons but a 4-million-ton increase over 1981. Production in West Siberia reached 354 million tons, a 20-million-ton increase over 1981. Production outside West Siberia declined by 16 million tons. [redacted] 25X1

With an annual production increase of less than 1 percent for the second year in a row, however, oil production has nearly reached a plateau. The plan for this year calls for production of 619 million tons, or a daily rate of 12.38 million barrels. Soviet hopes for continued production increases hinge primarily on continued growth in West Siberia, where an increase of 18 million tons is planned for this year. The Soviets also must reduce the annual decline in regions outside West Siberia from 15 and 16 million tons respectively over the past two years to the planned level of 12 million tons to meet their production goals for this year. [redacted] 25X1

Canada Approves New Natural Gas Exports

Canada's National Energy Board (NEB) has authorized the additional export of 330 billion cubic meters (bcm) of natural gas. Of the newly authorized volumes, 265 bcm was allocated to markets in the United States with the remaining 65 bcm set aside to support Dome Petroleum's proposal to ship liquefied natural gas to Japan. Although the NEB's decision more than doubles the authorized export level, it will provide less than half of the natural gas that had been sought by US buyers for markets in the northeastern United States. According to the NEB, the expense of expanding the pipeline from Alberta discouraged approval of the full request. Because the NEB hearings did not include a formal application for export of gas from Sable Island or other gasfields offshore Nova Scotia, we believe the NEB probably will authorize additional exports to the northeastern United States at a later date. Actual gas deliveries remain subject to approval by federal and provincial authorities in Canada and by US regulators. [redacted] 25X1

Potential Problems in Saudi Gas Project

[redacted] cutbacks in Aramco's capital investment 25X1 budget could lead to major problems in Saudi Arabia's master gas system. To complete the nonoil–associated Khuff gas project at the beginning of 1985—one year early—Aramco has decided to eliminate sour-gas handling facilities at the wellhead. This will reduce the $300 million cost of the program by an es-

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timated 30 percent. As now envisioned, sour gas from the Khuff formation underlying the giant Ghawar oilfield will be piped directly into the Saudi master gas system for treatment in existing natural gas processing centers. Left untreated, however, the carbon dioxide and hydrogen sulfide in the gas could eventually cause severe corrosion, requiring the costly replacement of large sections of gas pipeline. Khuff gas is needed to offset the drop in associated gas output as a result of projected lower levels of Saudi crude oil production. [redacted] 25X1

Planned Increase in UAE Oil Production

The announcement by the United Arab Emirates that it intends to increase oil production by one-third is another step in an apparently coordinated series of moves by the Persian Gulf states to force other OPEC nations into line on prices. The government justified its decision on the grounds of economic need. There are conflicting reports about whether the nations of the Gulf Cooperation Council will meet soon to consider their next move. [redacted] 25X1

The UAE posted a $3.8 billion current account surplus last year, and the claim of economic need is specious. At its current production rate of 1.2 million barrels per day, the UAE would still earn enough this year to allow for increased imports and a $2.7 billion surplus. Abu Dhabi would almost certainly have to cut its oil price to sell the larger amount. The UAE's statement lends support to press reports warning that the Arab Gulf producers will cut prices by $4 per barrel if OPEC fails to agree soon on prices and production quotas. [redacted] 25X1

Possible Saudi Oil Sales for Iraq

Saudi Arabia is negotiating to sell 40,000 barrels per day of Saudi oil to Japan on behalf of Iraq, [redacted] Japanese companies believe Saudi Arabia is planning similar arrangements with other oil importers to make up the difference between the proposed OPEC production quota of 1.2 million b/d for Iraq and its current production of about 850,000 b/d. [redacted] 25X1 25X1

Saudi Arabia is likely to view such deals as an alternative to direct cash assistance to Iraq, which it has been reluctant to provide because of its own financial difficulties. The contract with Japan, however, would be worth less than $500 million to Iraq over one year. Even if Riyadh were able to sell the 350,000 barrels a day for Iraq at the $34 benchmark price, the resulting revenue would not be enough to eliminate the need for cutting imports. The weak world oil market, moreover, probably would dictate lower exports or sales at lower prices. [redacted] 25X1

Big Seven Electricity Consumption Falls

During the first nine months of 1982, electricity demand in the Big Seven declined 1.3 percent—about 270,000 b/d oil equivalent—primarily because of sluggish economic growth. Electricity demand in the United States and the United Kingdom dropped by more than 2.5 percent. In France, where

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economic growth was slightly stronger, electricity demand increased by about 3 percent. Most forecasters expect electricity demand in the Big Seven to grow by about 3 percent in 1983 if the economic recovery materializes as expected.

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Increase in OECD Nuclear Power Output

Nuclear power generation in OECD countries increased 8.3 percent in 1982 and accounted for about 15 percent of total OECD electricity generated. Six new reactors, with a capacity of 6,055 megawatts-electric (MWe), entered commercial operation last year while one reactor (150 MWe) was retired. Prospects for additional growth are good as 13 plants, with a capacity of 11,268 MWe, already are undergoing startup and low-power testing.

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Improved performance and the addition of new reactors boosted nuclear electricity output in Japan and West Germany by 25 and 19 percent, respectively. Nuclear electricity generation in Western Europe increased nearly 10 percent. France's rapidly growing nuclear power program stalled in 1982 with no new plants entering commerical operation while several existing plants required more extensive maintenance and repair.

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OECD: Nuclear Electric Generating Capacity and Output

	Installed Capacity [a] *(thousand MWe, net)*		Gross Electricity Generation *(billion kWh)*	
	1981	1982	1981	1982
OECD	**127.6**	**133.5**	**708.8**	**767.6**
United States	55.3	57.6	288.6	298.7
Western Europe	52.0	54.0	293.4	321.8
Belgium	1.7	2.6	12.8	15.6
Finland	2.2	2.2	14.5	16.5
France	20.2	20.2	105.2	108.9
Italy	1.4	1.3	2.7	6.8
Netherlands	0.5	0.5	3.7	3.9
Spain	2.0	2.0	9.4	8.8
Sweden	6.5	6.5	37.7	38.8
Switzerland	1.9	1.9	15.2	15.0
United Kingdom	7.0	7.0	38.9	44.1
West Germany	8.6	9.8	53.3	63.4
Japan	15.0	16.6	83.5	104.5
Canada	5.3	5.3	43.3	42.6

[a] Net installed capacity, excluding plants that have gone critical but are still in startup and low-power testing.

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Ecuador To Assume Texaco's Oil Operations

Ecuador's state oil company, CEPE, has notified Texaco that it intends to assume responsibility for all operations of the CEPE-Texaco consortium as of 1 January 1985. The original 1965 concession awarded to the then Texaco-Gulf joint venture provided for a changeover in operators every 10 years. The 1975 changeover from Texaco to Gulf never occurred when Gulf decided instead to sell its share of the project to CEPE. There is some question of CEPE's legal right to become the operator, but Texaco apparently is not planning to challenge the move. As operator, CEPE will assume all responsibility for exploration, development, and construction; the agreement technically will not affect Texaco's assets or access to crude. The CEPE-Texaco venture produces over 90 percent of Ecuador's current crude oil production of 220,000 b/d. [redacted] 25X1

Thailand Begins Commercial Oil Production

Crude oil production began in mid-January at a Shell field in Kamphaeng Phet Province, 400 kilometers north of Bangkok. Shell expects production to increase from the current rate of 5,000 b/d to 17,000 b/d by 1985; recoverable reserves are estimated at 20-35 million barrels. The field also is producing a small quantity of natural gas that eventually will fuel an electric power plant. Although the Phet crude is high-gravity, low-sulfur oil, it has a high wax content and will solidify below 35° C, necessitating complicated transportation and refining procedures. Bangkok is buying the crude at a provisional price of $28 a barrel while negotiations for a long-term contract continue. Although 17,000 b/d will replace less than 10 percent of Thailand's petroleum imports, it will reduce somewhat the country's nearly $3 billion a year oil import bill. [redacted] 25X1

International Trade, Technology, and Finance

East German Purchases of Canadian Grain

East Germany in late January purchased 1 million tons of Canadian grain on the basis of two-year commercial credits guaranteed by the Canadian Government. [redacted] 25X1 25X1

The sale, Canada's first major entry into the East German grain market, undoubtedly will erode the US share, which in recent years has accounted for roughly two-thirds of East German grain imports. Since the late 1970s, the United States and East Germany have informally agreed to sales of 1.5 to 2.0 million tons of US grain annually. So far in the current marketing year ending 30 June, US exports have totaled approximately 400,000 tons, one-fourth to one-fifth of estimated East German grain imports for the year. Berlin diversified its sources of grain to obtain more favorable financing and probably to respond to a perceived US policy of economic discrimination. In the past year US grain traders and bankers generally have refused to grant the two-year financing insisted upon by the East Germans. [redacted] 25X1

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[redacted] 25X1

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Morocco Receives French Financial Assistance

France's recent $255 million loan and export credit to Morocco will provide Rabat with needed foreign exchange and support for the country's deteriorating external accounts. This financial package is a strong indication that Paris intends to remain Morocco's principal trading partner and its primary Western source of foreign financing. The financial agreement last month followed a French Government decision not to make additional assistance contingent on resolution of Morocco's arrears on military purchases which again have begun to accumulate. The signing of the accord preceded President Mitterrand's first visit to Morocco and reflects in part growing French concern over US influence in the region. [redacted] 25X1

National Developments

Developed Countries

Limited Policy Stimulus for Japanese Economy

In outlining Tokyo's economic program, Jun Shiozaki—Director General of the Economic Planning Agency (EPA)—indicated that the government's options for stimulating the economy are limited. With cutting the government budget deficit a key goal of the Nakasone cabinet, Shiozaki argued that only token fiscal stimulus, in the form of tax concessions for small business and depressed industries, is possible. While there is leeway to loosen monetary policy, Japanese authorities fear easier credit will renew downward pressure on the yen and arouse the indignation of Japan's trading partners. A discount rate cut planned for January was abandoned when the yen started to fall against the dollar. [redacted] 25X1

Japanese Trade Surplus Falls

Japan registered an aggregate trade surplus of $18.2 billion last year, compared with $20 billion in 1981. The surplus with the United States was $15 billion, down from $17 billion. Exports slipped 7.9 percent in value and 3 percent in volume as the global recession and export restraints offset improvements in price competitiveness because of the weak yen. The declines in motor vehicle and consumer electronics sales were particularly sharp. Restocking of

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raw material inventories and increased imports of semimanufactures early in the year kept import volume at roughly the 1981 level. Imports fell about 7.8 percent in value, however, mostly because of lower oil and raw material prices. Crude oil imports, reflecting the domestic economic slowdown and conservation gains, fell by 7 percent in volume terms. A narrowing of the deficit on services and transfers—caused in large part by an increase in investment income from Japan's rapidly growing direct overseas investments—pushed the current account surplus to $6.9 billion compared with $4.8 billion in 1981. 25X1

Japan's trade and current account surpluses probably will expand this year. Strong price competitiveness combined with economic recovery overseas should boost exports, while improved domestic growth should spur imports. Soft prices for oil and raw material probably will hold down the total import bill. We believe the trade surplus this year will reach $23-25 billion; the current account surplus should total $10-12 billion. 25X1

Less Developed Countries

Mexico Reassures Creditors

On a recent trip to the United States, Europe, and Japan, Treasury Secretary Silva Herzog and other Mexican financial officials reassured international creditors that the possibility of lower oil revenues had been considered in drawing up the 1983 budget and would not jeopardize Mexican repayments. Mexican Treasury officials estimate that the recent decline in interest rates will offset some of the drop in oil prices and have stated that 1983 interest payment projections of $12 billion were deliberately overstated. While Mexico may be able to handle a slight oil price decline, we believe a substantial drop in oil earnings would not be offset by falling interest payments and would severely limit de la Madrid's economic policy alternatives. 25X1

In a separate move, officials from the Ministries of Energy and Foreign Affairs recently visited six oil-exporting nations, apparently to lay the groundwork for cooperation with other oil producers without joining OPEC. Mexico City has publicly announced that it will not undercut OPEC by reducing prices to increase exports. We believe, however, Mexico will reluctantly lower its prices to maintain its market share. 25X1

Lebanese Central Bank Rebuffs Jumayyil

Lebanon's central bank has informed President Jumayyil it will not lend his government foreign exchange for reconstruction until the cash-starved treasury can assure steady collection of tax revenues. The central bank's decision precludes a major government reconstruction program any time soon. Customs duties, Beirut's main source of tax revenue, dropped last year to $106 million—barely half of the 1980 total. Revenue growth will be slow because the Lebanese Forces, a powerful Christian militia, has refused to turn over control of several lucrative illegal ports to the central government. Meanwhile,

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the Arab states of the Persian Gulf are unlikely to grant Jumayyil significant reconstruction aid while Israeli forces remain in Lebanon or if he goes too far in normalizing relations with Israel. The World Bank also has been reluctant to provide reconstruction loans. [redacted] 25X1

Threat to Southern African Food Supplies

Western donors may be asked to supply substantially increased emergency food relief this year to southern African states as drought threatens to curtail food exports from Zimbabwe and South Africa. A second year of drought is reducing Zimbabwe's projected output of foodgrains and is forcing emergency slaughter of livestock. Market deliveries of corn, the region's principal staple and an important Zimbabwean export, will fall by 50 percent in 1983. According to US Embassy reporting, corn stocks will fall to the level of annual domestic consumption and Harare may be reluctant to make much corn available for export to drought-stricken Tanzania and Mozambique, or to the chronically food-short Shaba region in Zaire. Zimbabwe itself may seek assistance in overcoming wheat and vegetable oil shortages. [redacted] 25X1

Drought also has intensified in South Africa, the world's fifth-largest corn exporter. Last month officials in Pretoria discussed a suspension of corn exports but delayed a decision until more precise crop estimates are available. Botswana and Zambia—traditional purchasers of South African corn and major recipients of international food aid—are plagued by the same drought conditions. [redacted] 25X1

The drought is adding to the dismal outlook this year for Zimbabwe's economy, already beset by fuel shortages, declining mineral exports, and a slump in manufacturing. The drought's intensity in the cattle-raising region of Matabeleland, the home of Zimbabwe's disaffected Ndebele tribal minority, also will compound Harare's difficulties in maintaining internal security. Pretoria may be tempted to try using South Africa's limited food surplus as leverage to gain political concessions from its black neighbors. These states, however, probably will prefer to turn to the West for additional food assistance. [redacted] 25X1

Results of Southern African Economic Conference

Leaders from the nine black African states comprising the Southern African Development Coordination Conference—Angola, Botswana, Lesotho, Malawi, Mozambique, Swaziland, Tanzania, Zambia, and Zimbabwe—held their third annual meeting late last month in Maseru. Representatives from 29 donor countries and numerous international organizations also attended, reportedly pledging around $200 million in new support for agricultural, industrial, transport, and other regional development projects. This would bring to about $1.6 billion the amount of foreign aid reportedly promised for projects sponsored by the organization since its formation in 1980. Even with increased international assistance, however, the nine states are unlikely in the near future to reduce significantly their dependence on South Africa. The aid

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commitments and the member countries' technical capabilities are too limited to accomplish this goal, and Pretoria probably will continue its efforts to keep neighboring states—especially those that assist anti–South African insurgents—unstable and economically dependent. [redacted] 25X1

Austere Zambian Budget

In an attempt to strengthen its case for a $225 million, one-year standby loan from the IMF, Zambia last week announced a budget for 1983 that calls for large cuts in government spending and substantial increases in taxes. Lusaka is projecting a deficit of $270 million, half of last year's deficit. Although this equals almost 10 percent of GDP, the US Embassy believes this figure may be acceptable to the Fund in view of the depressed state of the Zambian economy. The Fund will monitor Lusaka's spending carefully, however, because of the government's massive budget overruns in recent years. The temptation for pump priming will be particularly strong when President Kaunda's campaign for reelection gets under way later this year [redacted] 25X1

Status of Libya's Agricultural Program

Libya's large-scale agricultural development projects continue to have only limited success, and Tripoli remains dependent on imports for about 70 percent of consumption. Bottlenecks in distribution are keeping key inputs from being available on time. In particular, scarce water is allocated wastefully according to political demands. Delays in government funding—worsened by revenue shortfalls last year—are hampering needed purchases of imported equipment. A more basic problem is the disaffection of the rural labor force with Qadhafi's collectivist land policies and agricultural price controls. In addition, US trade restrictions are beginning to affect Libya's development projects in the desert; the 1982 summer grain harvest was delayed because of a shortage of US-made spare parts. [redacted] 25X1

Communist

East European–Soviet Trade

East European imports from the USSR rose 8 percent in the first nine months of 1982 as compared with the same period a year earlier; exports were up 12 percent. The slower rise in imports in 1982 suggests that East European countries have not redirected trade to compensate for a 20-percent cutback in imports from the West. The increase in exports probably reflects pressure by Moscow on East European countries to reduce their bilateral trade deficits. [redacted] 25X1

Poland and Romania, which made the deepest cuts in hard currency purchases, lowered imports from the USSR by 3 and 10 percent, respectively. Bulgaria, East Germany, and Hungary increased imports by approximately 10 percent, while Czechoslovakia had a 19-percent rise. Yugoslavia increased its imports by about 7 percent. Most, if not all, of the import growth resulted from higher Soviet prices and thus represents little gain in the volume of resources

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shipped. The decrease in Eastern Europe's trade deficit with the USSR in the first three quarters of this year suggests that Moscow provided less help last year than in 1981 to its financially strapped neighbors. [redacted] 25X1

East European Trade With the USSR *Billion US $*

	January-September 1981			January-September 1982		
	Exports	Imports	Balance	Exports	Imports	Balance
Total	**24.6**	**26.8**	**−2.2**	**27.6**	**28.9**	**−1.3**
Bulgaria	3.8	4.5	−0.7	4.5	4.9	−0.4
Czechoslovakia	4.3	4.3	−0.1	4.8	5.2	−0.3
East Germany	5.4	5.6	−0.2	5.9	6.3	−0.4
Hungary	3.4	3.4	NEGL	3.7	3.7	NEGL
Poland	3.4	5.1	−1.7	4.0	4.9	−1.0
Romania	1.7	1.5	0.2	1.8	1.4	0.4
Yugoslavia	2.8	2.3	0.4	2.9	2.5	0.4

[redacted] 25X1

Bank of China to Extend Export Credits

The Bank of China—China's official foreign exchange bank—will begin extending export credits to promote sales of Chinese machinery and ships. The credits will amount to $500 million over the next three years. The pilot program will begin in Beijing, Shanghai, Tianjin, and Dalian; increases in foreign competition for export sales may compel Beijing to expand the subsidies. [redacted] 25X1

The Bank also will continue making domestic loans to help small- and medium-size firms purchase foreign equipment and technology for technical upgrading. This year's economic plan calls for a 25-percent increase in imports—led by technology and industrial raw materials. The Bank currently has over $8 billion in foreign exchange reserves after two years of record trade surpluses. We believe US firms stand to gain from increased Chinese imports, although cutbacks in imports of US grain, cotton, and other products in retaliation for textile quotas may reduce the overall growth of US-Chinese trade. [redacted] 25X1

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Ecuador: The Debt Problem [redacted]

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Ecuador's financial troubles have mounted as successive oil booms triggered government spending and investments, which outpaced petroleum revenues. Last year the government encountered growing difficulty in financing its spiraling fiscal and current account deficits. Quito started negotiations with its creditor banks in late 1982 when it became apparent that it could not cope with mounting debt strains. Final approval of recent tentative agreements to refinance $5.6 billion of public debt is contingent upon the outcome of ongoing negotiations with the IMF. [redacted]

Ecuador will have to reduce the size of the fiscal deficit, enforce a tight monetary policy, and close the gap between the official and the market exchange rate to secure additional foreign credit and IMF assistance. These measures, however, will delay recovery and heighten social and political pressures. The coming months will be especially difficult. The Hurtado administration will continue to face sagging revenues for oil and other commodities. If Quito fails to adhere to austerity measures, IMF assistance expected in February or March probably will be discontinued after the first drawing. The long-run overall economic outlook for Ecuador is bleak. President Hurtado—much like his predecessors—is still adhering to short-sighted, oil-dependent policies and avoiding politically sensitive policy shifts, which limit his ability to deal with the underlying causes of Ecuador's economic problems. [redacted]

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Ecuador: Financial Indicators

Million US $

	1973	1974	1975	1976	1977	1978	1979	1980	1981 [a]	1982 [b]
Current account balance	**−12**	**22**	**−239**	**−30**	**−377**	**−730**	**−635**	**−772**	**−1,116**	**−1,400**
Trade balance	187	350	7	259	40	−175	73	303	209	50
Exports, f.o.b.	585	1,225	1,013	1,307	1,401	1,529	2,170	2,510	2,568	2,470
Of which:										
Oil	282	693	516	565	484	523	1,032	1,394	1,560	1,200
Bananas	125	125	157	146	163	180	200	241	229	210
Coffee	65	68	64	205	157	281	263	130	106	120
Cacao	26	103	42	33	59	50	41	31	44	100
Fish	0	0	37	54	73	89	123	156	182	220
Imports, f.o.b.	398	875	1,006	1,048	1,361	1,704	2,097	2,207	2,359	2,420
Net services and transfers	−199	−328	−246	−289	−417	−555	−708	−1,075	−1,325	−1,450
Foreign exchange reserves [c]	210	319	253	477	623	636	722	1,013	632	200

[a] Estimated.
[b] Projected.
[c] Excluding gold.

[redacted]

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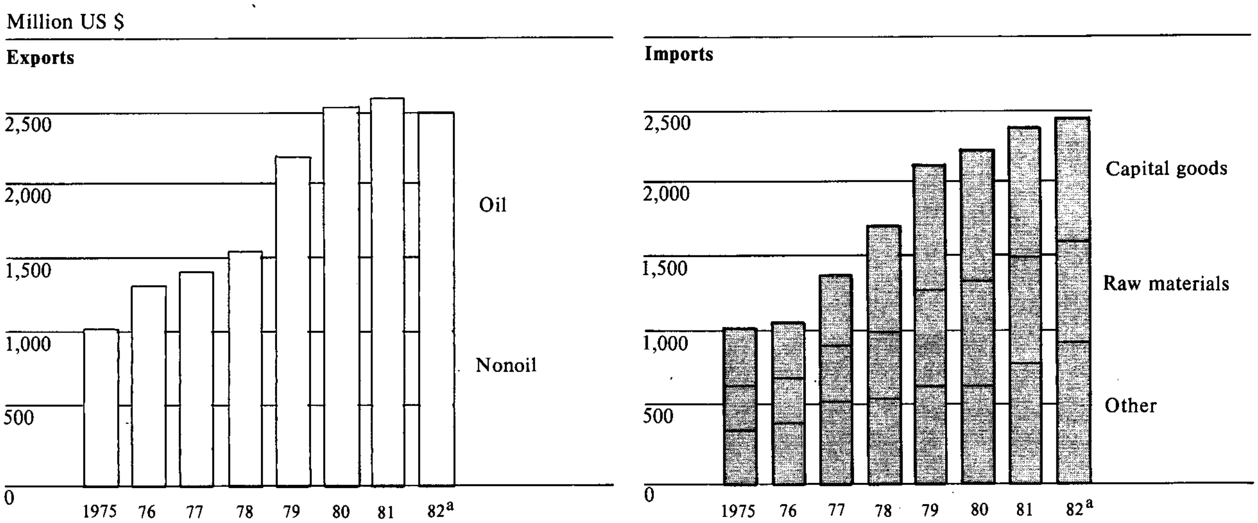
Ecuador: Trade Composition



[a] Estimated.

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The Legacy of the Problem

Ecuador historically has relied on a few commodities to finance social and economic development. Bananas replaced coffee as the principal export in the early 1950s and, by 1960, accounted for about two-thirds of total exports. By the early 1970s, oil supplanted bananas as the primary earner of foreign exchange. 25X1

The jump in oil prices in 1973/74 brought in greatly increased revenues, but also triggered additional government spending. Quito pursued large investment projects such as the state refinery at Esmeraldas and, at the same time, channeled funds into education, health, and housing. Expenditures rapidly outpaced cash inflows, and inflationary pressures mounted. 25X1

In a politically motivated attempt to combat inflation, the population was treated to low-priced petroleum and food products. Costly government subsidies on petroleum encouraged domestic consumption, decreasing the exportable surplus needed to generate additional revenues, while the lack of further oil exploration significantly depleted proved reserves. Moreover, cheap domestic oil prices led to an overdependence on petroleum for electricity generation. Low food prices and tight agricultural credit hindered domestic incentives to increase food output, necessitating the import of increasing amounts of foodstuffs. 25X1

Large oil revenues swamped the country's management capabilities. Ill-conceived development policies undermined efforts at economic diversification and pushed imports ever higher. Import-substitution strategies—designed to promote industrial development by restricting imports of manufactured goods—proved unsuccessful and increased dependence on both imported capital goods and raw

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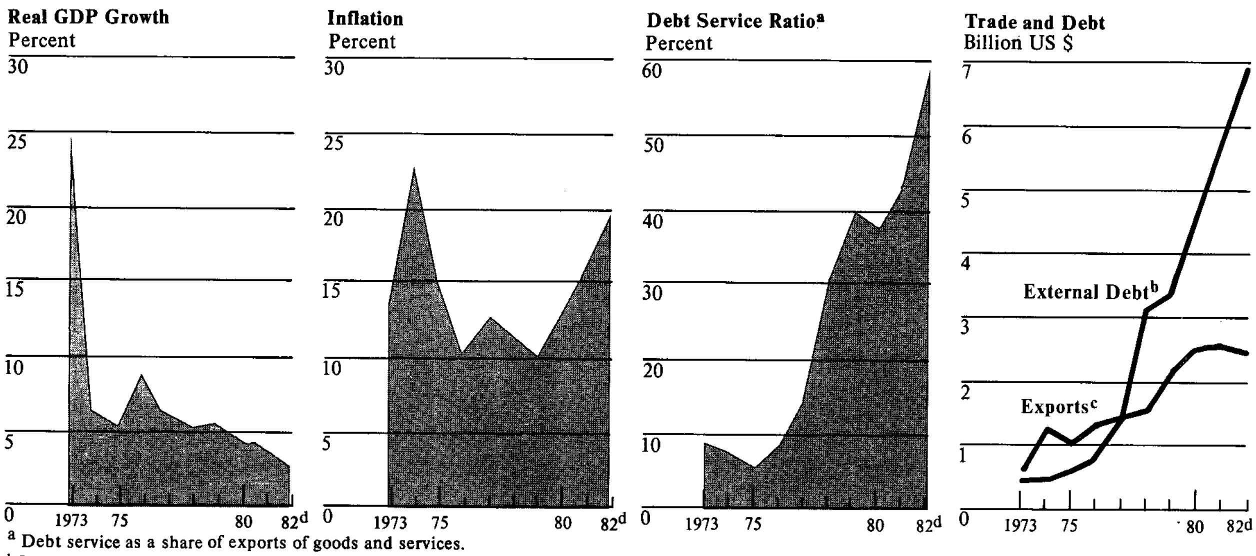
Ecuador: Economic Profile



[a] Debt service as a share of exports of goods and services.
[b] Includes short-, medium-, and long-term debt.
[c] Total merchandise exports, f.o.b.
[d] Estimate.

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materials. Massive development projects were funded through uncontrolled foreign borrowing by state corporations. Consequently total external debt soared to $3.1 billion by yearend 1978, up from $435 million in 1973. Despite increasing oil exports, the debt service ratio more than tripled to over 30 percent by 1978.

The Roldos-Hurtado Years

Since 1979, former President Jaime Roldos and his successor, President Osvaldo Hurtado, have tried to curb previous excesses. A tight monetary policy, for example, did not succeed in slowing inflation, but interest rates were allowed to rise in an attempt to slow capital flight and shore up investor confidence. The sucre also was devalued to restore export competitiveness.

The most difficult decisions, however, have been avoided. Quito has been unwilling to broaden revenue sources by imposing higher taxes. Only limited progress has been made in scaling down the ambitious goals of the 1980-84 National Development Plan, and the government has failed to trim the losses of the large state sector that accounts for half of public expenditures. In addition, austerity measures have been watered down in the face of popular opposition. Gasoline price increases, for example, unleashed general strikes and civil disturbances that forced Quito to backpedal. Moreover, the government granted wage increases to soften the impact of its austerity program. At the same time, foreign borrowing continued to grow; foreign debt reached $6.8 billion by yearend 1982. Private foreign banks, mainly US, hold almost 70 percent of the total.

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Ecuador—an OPEC member and the third-largest oil exporter in Latin America—has been hard hit by the falloff in world oil consumption. Oil revenues in 1982 totaled $1.2 billion compared to $1.4 billion in 1980.

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Coping With the Financial Crisis

Negotiations with the IMF are still under way. Ecuador's quota in the IMF is $75.6 million, including a freely available gold tranche of some $19 million and a "standby" quota of $57 million. Possible use of the Extended Fund Facility, the compensatory financing mechanism, and other IMF programs reportedly could give Ecuador access to an additional $380 million. Key conditions for an IMF agreement focus on the size of the fiscal deficit, monetary policy targets, and the foreign exchange rate. The IMF probably will press to close the gap between the free market value of the sucre—60 sucres to the dollar—and the official exchange rate of 33 to one. Fund officials will also recommend tight control on the expansion of domestic credit to curb inflation and, as in the case of Peru, may prescribe a short-term debt ceiling. 25X1

Outlook

Depite the success of the debt renegotiation effort, we foresee 1983 as a particularly difficult year for Ecuador. Declining oil revenues are exposing weaknesses and vulnerabilities that the two successive oil booms did little to eliminate. The economy remains dependent on oil for about half of export earnings and 35 percent of total government revenues. Tight fiscal and monetary policy are slowing growth. Another large devaluation of the sucre may be necessary because the economic measures have neither reduced capital flight nor increased domestic liquidity. Increased strikes and the continued lack of private investment—reflecting political uncertainties—will exacerbate prospective declines in manufacturing output. Moreover, recent floods—after four years of drought—have lowered crop estimates for 1982-83. The expected revenue gains from ongoing negotiations for oil export contracts with Israel and the USSR—for Cuba—and from the hoped-for lifting of the US embargo on Ecuadorean tuna may be offset by further oil price declines. 25X1

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Prospects for a successful resolution of Ecuador's financial difficulties this year are dim. Ecuador probably will muddle through its financial crisis—seeking "quick fixes" to short-term problems and neither attacking the roots of the country's economic ills nor making significant progress in holding to austerity programs. Although President Hurtado wants to implement tough austerity measures—reduce the budget deficit, further cut gasoline and wheat subsidies, and devalue the sucre—popular opposition will sharply constrain his ability to act. Even if the Hurtado administration reaches an agreement with the IMF, as we foresee, continuing backsliding from austerity after the first drawing would endanger subsequent IMF assistance. In this case, a renewal of the lending cycle would arise. Ecuador would again have to go to its foreign private creditors for relief and they, in turn, would demand strict adherence to IMF guidelines. 25X1

If Ecuador fails to reach agreement with the IMF and creditor banks, economic disruptions would become pronounced. The social and political pressures stemming from the continuing economic deterioration would increase and labor unrest would intensify, providing Hurtado's military opponents with a rationale for intervention. 25X1

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Ecuador has yet to take a firm stance to manage the economy over the longer term. Many of the necessary policy shifts are politically sensitive and Hurtado has not been able to build the political consensus that would permit the measures required for long-term economic development. Petroleum will remain a key source of revenue through the mid-1980s, but unless subsidies are reduced and exploration is increased, Ecuador will become a net importer of petroleum in the late 1980s. [redacted] 25X1

[redacted] 25X1

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Japan: Fiscal Constraints on Industrial Policy

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Tokyo's concern over its mounting fiscal deficit will constrain industrial policy–related expenditures in FY 1983, which begins on 1 April. Nonetheless, spending in this area will grow—unlike many other parts of the budget such as education and aid to local governments, which will be cut below FY 1982 levels.

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The Budget

Press summaries of the general account budget draft approved by the Cabinet in December indicate that spending on energy and science and technology, two categories that include many industrial policy programs, are to increase modestly but far less than last year. The projected rates of growth—6.1 and 1.5 percent, respectively—exceed the 1.4-percent rise in the total budget but compare unfavorably with the 13.2- and 4.7-percent increases in FY 1982.

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MITI has partially compensated for the tight general account budget by successfully lobbying for increases in the amount of money the Japan Export-Import Bank and the Japan Development Bank will be able to borrow through the Fiscal Investment and Loan Program (FILP). FILP will allocate some $85 billion from the postal savings system and national pension funds to public corporations and lending institutions in FY 1983. Even in this case, however, the slowing growth of postal savings deposits—the largest single source of FILP funds—has constrained spending. The FILP budget will increase only 2 percent in FY 1983, compared to 3.5 percent a year ago.

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Japan: General Account Expenditures for FY 1983

	Expenditures (billion US $) [a]	Percent Change From Initial Budget for FY 1982
Total expenditures	**214.4**	**1.4**
Social security	38.9	0.6
Education, science, and technology	20.5	−0.9
National debt expenses	34.9	4.6
Pensions	8.1	−0.1
Transfers to local governments	32.7	−20.4
Defense	11.7	6.5
Public works	28.3	0
Economic cooperation	2.1	7.0
Energy measures	2.5	6.1
Other	23.6	−3.4
Repayment to debt consolidation fund	9.6	NA
Reserves	1.5	0

[a] Based on an exchange rate of 235 yen per dollar.

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High-Technology R&D

Research and development projects already in progress emerged from the review of the general account budget with only slight, if any, reductions from MITI's original request:

- The top-priority Fifth-Generation Computer Project received the $12 million requested by MITI. This would push total spending on the 25X1

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project to $13 million since its inception in FY 1981. A large increase in funding will be necessary next year to meet MITI's expenditure goal of $43 million by the end of FY 1984. The bulk of the spending for this project will occur between 1985 and 1991.

- The Cabinet approved $25 million, $2 million less than MITI's request, for research on new materials, biotechnology, and new semiconductor elements. This represents a 22-percent increase over FY 1982 but is still well below the level of expenditures that will be necessary if MITI is to complete the $473 million program in 1990.

- Subsidies for the next-generation civil airliner and the RJ-500 jet engine projects will be reduced from 70 to 65 percent and 66.5 to 65 percent of the total cost, respectively. Tokyo will spend $10 million on the airliner and $20 million on the jet engine in FY 1983. [redacted]

Several new industrial policy programs have been included in the budget but at less-than-requested funding levels. MITI's new project to develop sensing robots with sophisticated sight and touch capabilities for use in mining, ocean resource development, and nuclear power plants received only $170,000 instead of the $4 million scheduled. The small appropriation probably reflects MITI's inability to identify research themes that would benefit the robotics industry as a whole rather than individual firms. [redacted] the project is unlikely to make a significant contribution to the robotics industry because the $65-85 million that MITI has planned to spend over the seven- to eight-year life of the project is too little to divert companies from their internal research programs. [redacted]

Other Spending

The new budget also helps declining as well as high-technology industries. MITI has secured $2 million to assist research and development in such industries as pulp and paper, chemical fertilizers, ferroalloys, and nonferrous metals. The government will subsidize up to 60 percent of research and development costs for technologies that offer some hope of restoring the competitiveness of these industries. In addition, the depressed aluminum smelting industry was allocated a $1.3 million subsidy for research on a blast furnace refining method that could lower the industry's energy costs dramatically. [redacted] 25X1

The politically important small business sector was not forgotten. The Small Business Finance Corporation and the People's Finance Corporation, two official institutions that specialize in lending to small firms, will receive subsidies of $17 and $32 million respectively to cover deficits. The deficits result from Tokyo's efforts to stimulate capital investment in the small business sector through interest rate subsidies. The actual subsidy is small because most loans exceed the cost of funds. Small 25X1 business will also benefit from a $5 million appropriation for Regional Frontier Technology Development Enterprises, which will build research institutes around the country to serve small business. MITI has also secured money to promote the development of venture capital firms. [redacted] 25X1

Loans for Energy, High Technology, and Overseas Investment

Within the FILP budget, top priority has been 25X1 given to financing natural resources and energy-related investments and imports. 25X1 A $500 million increase in Japan Export-Import Bank lending for such projects accounts for a major part of the 15.3-percent increase in the bank's budget. The Japan Development Bank's (JDB) resource and energy-related loan program—which finances nuclear 25X1 power plants, domestic oil companies, nonoil energy development, and energy conservation measures—will increase 4.3 percent to $2 billion. [redacted] 25X1

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Japan: Lending Programs of Major Official Financial Institutions in FY 1983

Billion US $

	Borrowing Through FILP [a]	Other Borrowing or Internal Funds	Total
Small Business Finance Corporation	7.1	2.2	9.3
Percent change [b]	3.3	3.3	3.3
Japan Export-Import Bank	4.4	1.3	5.7
Percent change [b]	14.8	17.7	15.3
Japan Development Bank	3.5	1.3	4.8
Percent change [b]	1.9	2.4	2.0

[a] Fiscal Investment and Loan Program.
[b] Percent change from FY 1982.

[redacted]

JDB's other high priority is its "development of technology" lending program, up 4.6 percent to $481 million. Within this program the distribution of funds between major projects is unlikely to change drastically in FY 1983. In FY 1982:

- 48 percent went to the development of the electronic computer industry.
- 42 percent went to the domestic development of new technology or machinery, including pilot manufacturing plants.
- 10 percent went to promote the use of high technology in designated electronic and machinery industries. [redacted]

The Japan Export-Import Bank also is emphasizing promotion of industrial cooperation with other Western industrial countries, [redacted] The bank's plans for FY 1983 include as much as $200 million in financing for the Nissan truck plant now under construction in Tennessee. Approximately $60 million has been allocated to finance the export of steel pipe for a coal pipeline in the United States. [redacted]

Revenues

The Ministry of Finance continues to hold a tight rein over special tax benefits for individual industries. Revenue losses from special tax measures as a percentage of corporate tax collections have declined from 9 percent 10 years ago to an estimated 1.8 percent in the present fiscal year. Even so, special tax measures of all kinds—special depreciation, tax-free reserves, and tax credits—will cost Japan's treasury an estimated $936 million in FY 1982. [redacted] 25X1

The highlight of the changes being made in FY 1983 is the beginning of phased repeal of the special 10-percent, first-year depreciation allowances that purchasers of many robots and machine tools presently enjoy. This decision also may be a reaction to the US industry's pressure on Washington—reflected by the Houdaille Industries petition—to declare US purchasers of Japanese machine tools ineligible for investment tax credits because of various forms of assistance Tokyo has given the Japanese industry. [redacted] 25X1 25X1

Ironically, major Japanese corporations now are complaining that US investment tax credits and the 10-5-3 accelerated cost recovery system give their US competitors an advantage. The Japanese press recently cited a comparison of Caterpillar and Komatsu, the world's number-one and number-two construction machinery manufacturers. In 1981 corporate taxes as a percentage of sales were 5 percent in Komatsu's case and only 2.4 for Caterpillar. A JDB calculation cited in the press holds that a US firm can write off capital investments in a seamless steel pipe mill in 6.6 years. A Japanese firm would require 8.3 years. The Japanese corporations propose to eliminate the disadvantage by reducing the useful life for depreciation of many fixed assets. [redacted] 25X1 25X1 25X1 25X1

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The Japanese Budgetary Process

Date	Event
Spring	Ministry of Finance (MOF) informally consults with ministries about requirements for the coming year.
June or July	The Cabinet approves MOF-proposed ceilings for budget requests being prepared by ministries. MOF also makes its first revenue and expenditure estimates during the summer.
End of August	Ministerial requests are presented to MOF.
September	MOF begins the examination and hearings process for requests.
Fall	MOF fits ministrial requests into a framework of revised revenue and expenditure estimates. This process is subject to considerable informal political pressure.
Late December	MOF budget draft is presented to other ministries. Presentation is followed by a week of "revival" negotiations during which other ministries and agencies, with the support of their allies in the Diet, argue for restoration of cuts made by MOF. Cabinet members and the three senior Liberal Democratic Party leaders meet at the end of the week to make final decisions.
Year's end	Government budget draft, which is almost never changed in the Diet, is approved by the Cabinet.
January-March	Government draft is presented to the Diet. Public hearings, committee deliberations, and passage by the Lower and Upper Houses follow. Opposition parties may delay passage to force concessions on other issues, but the contents of the budget generally remain unchanged.
End of March	Official budget is approved.
April	The new fiscal year begins.

[redacted] 25X1

The Outlook

The Diet normally passes the government budget draft virtually intact; this year is unlikely to be an exception. From a longer term perspective, the most striking development in the budget is the inclusion of new programs to aid declining industries. In addition to the general account items already cited, a press report indicates that the JDB may begin to finance the commercialization of new technologies that will improve the competitiveness of declining industries. Aid to these industries appears certain to expand in the future. [redacted] 25X1

Judging from the composition of the new budget, Tokyo will continue to support high-technology growth industries such as computers, which are considered essential to Japan's future but still vulnerable to foreign domination. In addition to budgetary measures, NTT continues to support the development of the computer, semiconductor, and communications industries. On the other hand, in the case of robotics, where Japanese companies are now highly competitive, the Ministry of Finance is showing sensitivity to domestic and foreign doubts about the need for official involvement. This sensitivity should persist as long as Japan continues to run large government deficits. [redacted] 25X1

[redacted] 25X1

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Japan: Evolving Policy Toward the Third World [1]

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Strategic considerations are playing a larger role in Japanese policy toward LDCs as Japan's own view of its national interests evolves and as Tokyo responds to US pressure to play a global role commensurate with its economic power. Foreign aid, particularly to strategically important Third World countries, has increased rapidly since the mid-1970s. We expect this trend to continue under Prime Minister Nakasone, although budget problems will slow the increase in aid commitments.

The Policy

Tokyo places a high priority on maintaining stable commercial relations with the LDCs, which are valuable markets for Japan's manufactured exports and supply much of the fuels, foodstuffs, and raw materials indispensable to Japan's survival and industrial growth. Japanese interest thus focuses on the relatively fast-growing East Asian LDCs, the raw material suppliers of ASEAN, and the oil producers in the Middle East.

While economics still dominate Tokyo's relations with LDCs, other factors began to play an important role in the late 1970s. Tokyo's reevaluation of its policy toward the LDCs was stimulated by Vietnam's invasion of Kampuchea in 1978 and the Soviet invasion of Afghanistan in 1979, which threatened stability in ASEAN and the Middle East. Underlying this, however, is a fundamental change still under way in Japan's overall foreign policy that reflects growing appreciation of the Soviet threat, a deepening self-confidence stemming from Japan's economic success, as well as US demands that Japan use its economic power to help deal with the Soviet challenge. The key policy tools have been aid, loans, and investment. We believe Tokyo's goals are to:

- Strengthen the economic underpinnings of political stability in the LDCs and reduce opportunities for Soviet intervention.
- Ameliorate US dissatisfaction with Japan's failure to "pay its dues" as a member of the club of advanced industrialized democracies.

The Aid

Total aid commitments denominated in US dollars increased rapidly in the late 1970s—from $1.5 billion in 1976 to $4.4 billion in 1980. Since then, growth has slowed as Tokyo has tried to trim its fiscal deficit and the yen has depreciated against the dollar. The Japanese Government has tended to favor bilateral over multilateral aid and is unlikely to step up support for multilateral institutions unless other aid donors, particularly the United States, are willing to move in tandem with Japan. In January 1983, however, Japan decided to join the African Development Bank and to subscribe $300 million.

Despite the budget crunch of recent years, economic assistance has fared well compared with other government accounts. In FY 1983, for example, aid increased by 8.9 percent while the total budget grew only 1.4 percent. Nonetheless, Japanese officials now doubt that the government will be able to achieve its goal of doubling aid disbursements over the 1981-85 period, compared with the previous five years. Future budget constraints will preclude the increases in commitments necessary to reach the target. 25X1

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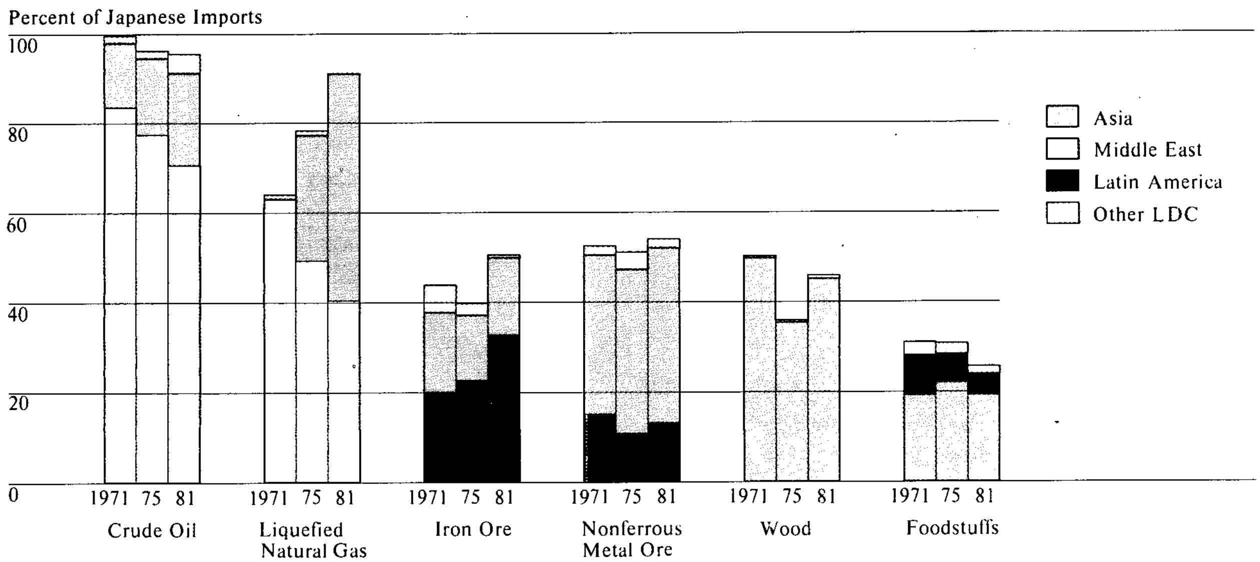
Japan: LDC Suppliers of Crucial Commodities, by Region



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Although the growth of aid commitments is slowing, political considerations are playing a greater role in determining the direction of Japanese aid. Southeast Asia—particularly Thailand, ASEAN's "frontline state"—has been the principal beneficiary of Japanese economic assistance. Malaysia, another key ASEAN state, capitalized on the $4 billion aid agreement just concluded between Seoul and Tokyo and recently persuaded Japan to boost its aid pledge for FY 1982 from about $90 million to $300 million. Japan has also increased aid to Turkey, Egypt, Pakistan, and other strategic countries in or adjacent to the Middle East. In addition, in response to US requests, Tokyo recently agreed to contribute $60 million in debt relief for Yugoslavia and $20 million to help support the Multinational Force in Lebanon.

The Outlook

International pressure and Japan's own estimate of its strategic requirements will continue to push it toward a more active relationship with the LDCs. The new Nakasone government will move further in this direction. Nonetheless, there are limits to how far and how fast Japan will proceed:

- Aid policy will continue to be driven by economic imperatives, and Asia will continue to receive the lion's share of foreign assistance.
- A severe budget crunch is likely to keep foreign aid from expanding rapidly.
- The strategic rationale for economic assistance will remain politically controversial in Japan, as was demonstrated most recently in aid negotiations with South Korea.

Although generally compatible with US interests, there are some negative implications for Washington in Japan's new approach. Where LDC demands are contrary to US policies, Japan may opt for a more accommodating policy because of its economic dependence on these countries. Japan's vulnerability to oil supply disruptions, for example,

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Japanese Aid to Strategic LDCs, 1981 [a]

Million US $

Asia	**1,448**
ASEAN	1,113
Indonesia	462
Thailand	286
Philippines	234
Malaysia	114
Singapore	18
South Korea	335
Middle East	**288**
Turkey	95
Pakistan	90
Egypt	72
Kenya	15
Somalia	6
North Yemen	4
Jordan	2
Sudan	2
Oman	1
Central America/Caribbean	**18**
Jamaica	10
Honduras	4
Costa Rica	2
Dominican Republic	1

[a] ODA, commitment basis.

[redacted]

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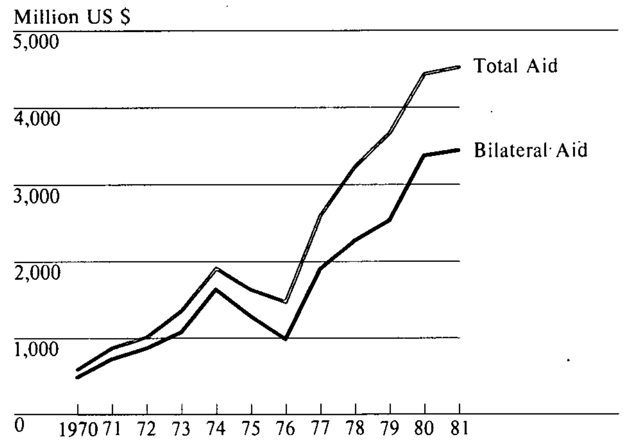
Japan: Foreign Aid Commitments [a]



[a] Official Development Assistance (ODA)

[redacted]

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will continue to make it more responsive to the concerns of Persian Gulf oil exporters. Tokyo also will try to convince Washington to accept its more positive approach to the LDCs as a partial substitute for significant expansion of Japan's defense capabilities.

[redacted]

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West German Arms Sales: Policies and Prospects [1]

West Germany, the world's fifth leading arms supplier, has sold more than $10 billion in military equipment and services during 1976-81. Although the new conservative government is likely to encourage more arms sales to strengthen the domestic economy and its national defense, West Germany will have difficulty holding its market share over the next several years. Domestic opposition to greatly increased sales is significant, and export restrictions remain fairly strong. Moreover, few new, expensive weapons systems are available for export, and the international market is increasingly competitive. In addition, Bonn will be cautious about weapons sales to the Middle East, the largest Third World arms market.

The West German Defense Industry

Although West Germany is the industrial leader of Europe, its armaments industry has remained comparatively small. It ranks fourth in Western Europe in terms of employment, accounting for less than 1 percent of the West German work force. This reflects a government policy to restrict the growth and importance of the arms industry to demonstrate West Germany's postwar commitment to peace. Bonn has laid out strict guidelines for the defense industry in its periodic defense white papers:

- The defense industry will operate on a private-enterprise basis, and, when possible, firms will diversify and avoid dependence on military business.
- West Germany will not seek self-sufficiency in defense production, and, whenever possible, major armament projects will be coordinated or developed jointly with its allies.

Selected West German Industrial Sectors: Dependence on Defense Production

	Aerospace/ Electronics	Vehicles/ Explosives/ Arms	Shipbuilding
Workers in defense	75,000	71,000	60,000
Of which:			
Number dependent on exports	22,500	7,100	9,000
Share of total production *(percent)*			
In defense	60	15	25
For export	30	10	15

Sources: Unclassified trade journals, West German and European Economic Community figures, and contractor studies.

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- The defense industry will serve West German and NATO defense and will not become dependent on arms exports. 25X1

These policies have made Bonn the strongest West European champion of defense collaboration and reciprocal arms purchases in NATO. They also have prevented the development of weapons primarily for export—except naval vessels—and have kept West German arms exports at about 0.5 percent of total sales. 25X1

Even though defense production accounts for less than 2.5 percent of total manufacturing output, several industrial sectors have become dependent on military business. For example, the shipbuilding industry receives about one-fourth of its orders

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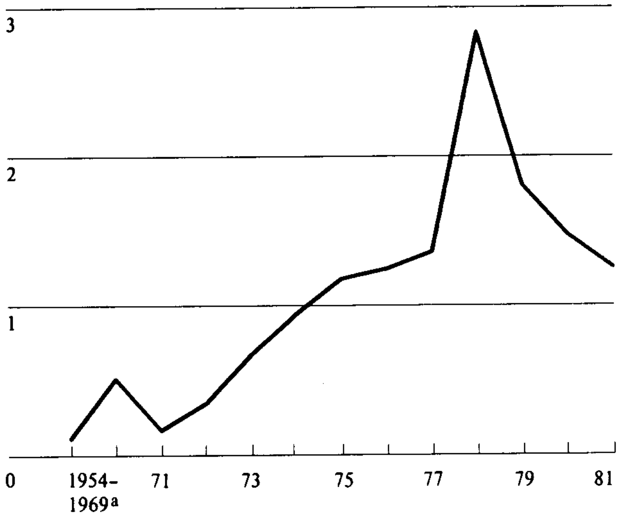
West Germany: Military Sales Trends

Billion US $



[a]Annual average.

[redacted] 25X1

Million US $

1954-69[a]	119
1970	517
1971	174
1972	355
1973	680
1974	954
1975	1,190
1976	1,256
1977	1,370
1978	2,836
1979	1,813
1980	1,484
1981	1,267

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from military customers, and the importance of this business—especially exports—has increased as worldwide demand for commercial shipbuilding has declined. [redacted] 25X1

Scope and Magnitude

West Germany sold more than $10 billion in military equipment and services to 83 nations during 1976-81.[2] More than two-thirds of West German sales go to the Third World, a proportion that has remained fairly constant over the past decade; Latin America and the Middle East account for almost 50 percent of West German arms sales. Argentina has been Bonn's major customer in recent years, with West German shipyards serving as prime contractors for nearly all of Buenos Aires' naval modernization program. The United States is West Germany's second-largest customer, spending about $150 million annually on military construction, consumables, and support. [redacted] 25X1

Equipment Sales. West Germany exports a wide range of military equipment. Over 40 percent of West Germany's sales to industrial nations are for ground forces equipment such as artillery and tanks, while only 3 percent of its contracts with developing nations involve ground weapons. In contrast, 50 percent of West German sales to the Third World are for naval vessels, with only 10 percent of sales to developed nations falling in this category. During the 1970s West Germany became the leading non-Communist supplier of warships to the Third World. A drop in naval sales since 1978 has been an important factor in the overall decline in West German sales. [redacted] 25X1

[2] This does not include an estimated $1.8 billion returned to West German arms manufacturers indirectly through sales of Alphajets and Euromissile products by consortium partners. [redacted] 25X1

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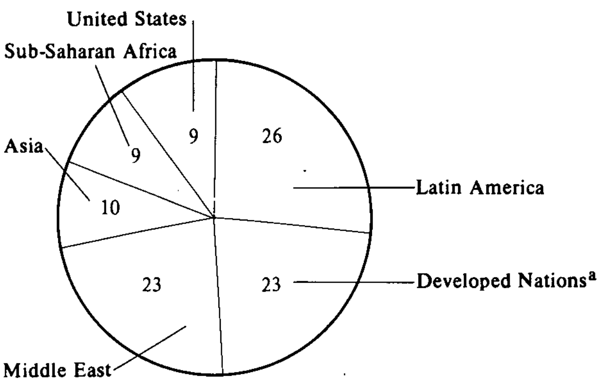
West Germany: Direct Sales by Regions, 1976–81

Percent



Total: US $10.0 Billion[b]

[a] Including Western Europe, Japan, Australia and New Zealand.
[b] Includes $8 million in sales to Communist nations.

[redacted]

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An unusual characteristic of West German military sales is the high percentage of nonlethal items. West Germany is the largest non-Communist exporter of military trucks, as well as a major supplier of electronic equipment and construction services. Of even greater significance are West German sales of military production technology and armament facilities through licensed assembly agreements. We estimate that at least 20 percent of West Germany's military sales fall in this category, more than any other major arms supplier. Such sales have contributed significantly to the emergence of defense industries in the Third World. [redacted]

A surprisingly small proportion of West German direct sales involve aircraft, helicopters, and missiles. West Germany produces all of its combat aircraft and missiles through international codevelopment and coproduction programs and benefits when consortium partners arrange exports of these systems. For example, France markets the missiles produced by Euromissile, a consortium between Aerospatiale and the West German firm, Messerschmitt-Boelkow-Blohm. Paris also promotes exports of the jointly produced Alphajet light attack aircraft. [redacted] 25X1

The New 1982 Export Policy

Flagging growth during 1976-81 was partly due to more stringent enforcement of the formal restraints on West German arms exports. Bonn has been forced to consider arms exports carefully because of strong opposition from church and peace groups and the left wing of the Social Democratic Party (SPD). [redacted] 25X1

We believe that corporate lobbying, increasing unemployment, and a growing balance-of-payments problem encouraged former Chancellor Schmidt to advocate a loosening of the export guidelines. In a speech to the Bundestag in January 1981, Schmidt stated that export orders for nonmilitary goods are often linked to Bonn's willingness to sell arms and that West German security interests have grown beyond the NATO area because of the nations's growing need for imports of oil and other raw materials. [redacted] 25X1 25X1

Despite these economic and political incentives, public controversy and a badly divided SPD-FDP (Free Democratic Party) coalition prevented Chancellor Schmidt from significantly relaxing export restrictions. On 3 May 1982 the government announced that none of the laws governing arms sales would change, but it modified the 1971 export-policy guidelines. [redacted] 25X1

We believe that the new guidelines give the government greater discretion with arms sales because the rules are ambiguous and because foreign or security policy interests now justify sales to the Third World. Nevertheless, sales to non-NATO nations still must serve defensive needs only, and must not go to nations where a danger of hostility exists or 25X1

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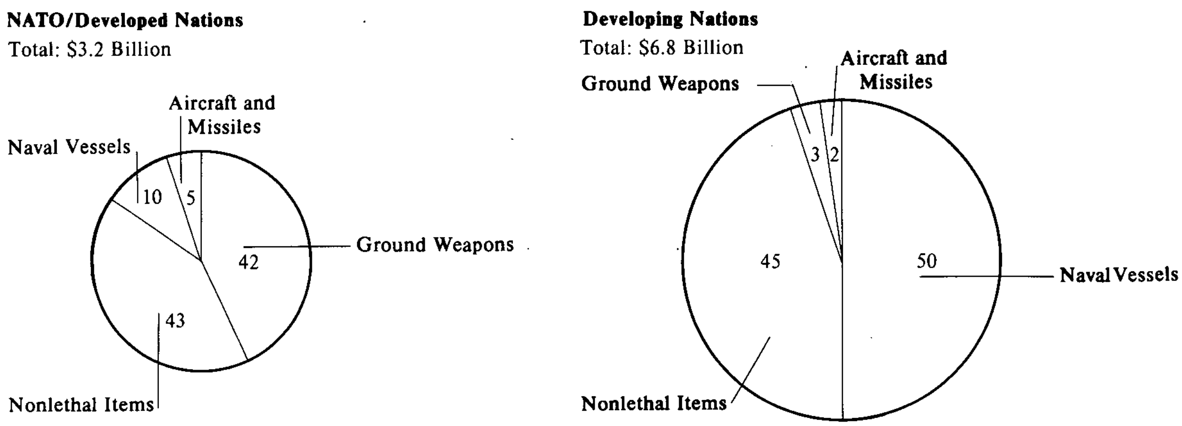
West Germany: Direct Sales by Type of Equipment, 1976-81

Percent



[redacted] 25X1

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where a sale would heighten local tensions. By allowing parliamentary participation on important cases, the new guidelines leave government decisions open to at least as much domestic political influence as before. [redacted]

Limited Government Sales Assistance

The federal government does not actively promote arms sales. There is no government defense sales office in West Germany, and the Ministry of Defense contains no office to promote exports or to consider the export issue when procuring weapons for West German armed forces. Attache reporting indicates that Bonn's military attaches do not carry out a sales role, in contrast to those of other West European nations. [redacted]

No direct financial support for arms exports is available from the federal government. Some export credit guarantees for military sales are available through the government-insured Hermes consortium of private banks, [redacted] 25X1 The terms are better than those generally available through normal commercial channels but not as concessional as those offered by France to important arms clients. Hermes also provides political and economic risk insurance for 10 to 15 percent of the value of sales, but most Hermes funds go for civilian exports. [redacted] 25X1

Private Promotion of Exports

West German firms, in our judgment, are as aggressive as their French counterparts in promoting exports. [redacted] 25X1

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Major Third World Recipients of West German Defense Production Assistance

Nation	Local Production
Algeria	Military explosives, artillery rockets
Argentina	Armored vehicles, naval vessels
Burma	Small arms, artillery ammunition
Brazil	Submarines
Chile	Antitank guided missiles
Egypt	Small arms, artillery ammunition
India	Trucks, electronics, military explosives, ammunition, submarines
Indonesia	Small arms, helicopters, naval torpedoes
Iran	Small arms, military explosives, ammunition
Singapore	Guided missile patrol boats
Sudan	Small arms ammunition, military printing plant

[redacted]

[redacted]

West German firms also stimulate sales in the Third World by offering licensed assembly arrangements and other defense production assistance. Defense production by West German subsidiaries or licensees in other nations are not covered by Bonn's strict export controls. [redacted]

West German firms have become proficient at arranging offsets to stimulate arms sales. Arms-exporting firms rely on trade associations and their nonmilitary, domestic customers to guarantee West German purchases from an arms customer that offset part or all of the cost of the arms sale. [redacted]

Outlook

We believe West Germany will have difficulty maintaining its market share during the next two to five years. The Alphajet, Tornado, and Euromissile programs have almost exhausted their market potential, and new production orders will eventually end by the mid-1980s when their technology will appear increasingly dated. We believe that the follow-on to the Tornado program is likely to be a European consortium aircraft. [redacted] the Agile combat aircraft seems to have the inside track. We also believe that warship sales will level off because of economic constraints on buyers, the near saturation of the naval market, and sharp competition from other shipbuilding nations. [redacted] 25X1

West Germany's best opportunity for major weapons sales probably will occur as Western nations such as Belgium and Switzerland modernize their ground forces. Bonn's greatest export potential in the developing world probably remains in the area of nonlethal equipment—vehicles, electronics equipment, construction, and defense technology. Domestic political controversy is less likely to hinder such exports, and many developing nations are placing more emphasis on building military infrastructure, logistics, command and control systems, and on indigenous defense industries. [redacted] 25X1

We believe that a new conservative government is more likely to approve weapons sales to the Third World. Although domestic sensitivities remain, a conservative government does not face major factional splits on the issue of allowing more direct sales of weapons. Currently, the coalition supports a generally restrictive arms export policy with a case-by-case determination of all sales based on foreign and security policy. [redacted] 25X1

[redacted] 25X1

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